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THE TAXATION OF FARMERS

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ISSUE DEFINITION

Throughout history the importance of agriculture has been recognized and farmers have been accorded a special role in society. Twentieth century Canada is no exception. Both the House of Commons and the Senate, for example, have standing committees devoted to agricultural issues. Marketing boards exist for certain agricultural products, and government expenditure and revenue policies often include special provisions for farmers. This review concentrates on such provisions in the Income Tax Act.

The attempt to give farmers special treatment under the Income Tax Act leads to the usual problem - those for whom the special treatment was not intended will endeavour to find a way to obtain it. The sections of the Income Tax Act dealing with farmers, therefore, must cope with two questions. The first is how to match the position of farmers with appropriate special treatment; the second is how to ensure that only farmers receive this treatment.

BACKGROUND AND ANALYSIS

The recent reform of the Income Tax Act included several provisions dealing with farmers, although not all those recommended in the White Paper on Tax Reform of June 1987. This review examines the recommendations in that White Paper, and shows how they were modified in the Ways and Means motion introduced a year later and in the resulting Bill C-139, An Act to Amend the Income Tax Act, which received Royal Assent in September 1988.

A. Who is a Full-time Farmer?

The problem of determining who is a full-time farmer is about as old as the Income Tax Act. Two years after the enactment of the Income War Tax Act of 1917 a provision was added to prohibit the deduction of losses incurred in a secondary activity from the income generated by a principal activity (the taxpayer's "chief position, occupation, trade, business or calling"). The provision was worded generally, but there is evidence that it was aimed primarily at part-time farmers.

Tests to distinguish part-time from full-time farmers changed over time. In 1948, an amendment altered the words "chief position, occupation, trade, business or calling" to "chief source of income." In 1951, farming activity was singled out from other businesses for special treatment: a limit of the lesser of one-half of farming losses or $5,000 could be deducted from all secondary sources of income.

In 1952, changes in the Act allowed taxpayers to aggregate income and losses from all activities and pay tax only on the net amount. The only exception was for part-time farmers, who retained the limit of the lesser of one-half of farming losses or $5,000 to be deducted against other income. In 1958, the limit was changed slightly, so the first $2,500 of losses for part-time farmers became fully deductible, instead of one-half deductible (the overriding limit of $5,000 remained).

No changes to this limit were made for three decades. During this time, of course, there were conflicts between the Department of National Revenue and taxpayers over what constituted the "chief source of income." Some guidance was provided in the 1977 Supreme Court of Canada decision in Moldowan v. The Queen.

This decision classified farmers into three categories, as described in the Department of Finance Discussion Paper "Tax Issues in Agriculture," January 1985, p. 23:

> (i) those for whom farming may reasonably be expected to provide the bulk of income or the centre of work routine;
>
> (ii) those who do not look to farming, or farming and some subordinate source of income, for their livelihood but carry on farming as a sideline business; and

(iii) those who do not look to farming, or farming and some subordinate source of income, for their livelihood and who carry on farming as a hobby.

In brief the three categories are: full-time, part-time and hobby farmers. The first may deduct all farm losses against other income; the second face the limits on deductible losses mentioned above; and the third may not deduct any farm losses because, as hobby farmers, they are not in the business of farming. Losses are calculated using cash accounting; in any year a loss is the difference between cash payments made during the year and cash receipts for the year. (The alternative to cash accounting is accrual accounting, which attempts to measure the actual use of resources during the year.)

To determine farming status, Revenue Canada uses two administrative tests. The first asks whether there is a "reasonable expectation of profit." If there is not, the taxfiler is a hobby farmer. If there is, the second test asks whether farming is the taxpayer's "chief source of income." If it is not, the taxfiler is a part-time farmer and subject to section 31 of the Income Tax Act, which deals with the restricted farm loss for part-time farmers.

The following table shows the split in 1981 between full-time and part-time farmers, determined by comparing gross farm revenues with off-farm incomes, and provides information on farm losses.

Profile of Individuals Reporting Net Farming Losses, 1981

	Full-time farmers	Part-time farmers	Total
Number of individuals in category	277,604	174,800	452,404
Number of individuals reporting a loss	48,605	124,074	172,679
Percentage of individuals in category reporting a loss	17.5%	71.0%	38.2%
Total losses ($ million)	423.1	618.8	1,041.9
Amount restricted ($ million)			86.8
Number of individuals with a restricted loss			34,471

Source: Department of Finance, *Tax Issues in Agriculture*, January 1985, p. 24, Table 10 (based on Revenue Canada taxation data).

The "restricted losses," i.e., those above the section 31 limits, may be carried forward for ten years or back for three to be claimed against farm income, and thus represent a possible loss of tax revenue to the government.

Though the two administrative tests both have problems of interpretation and have been the subject of court cases, no unambiguous, objective tests have emerged to replace them. The greatest problem with any test has to do with the treatment of start-up farmers and farmers in financial difficulty.

B. The White Paper Proposals (18 June 1987)

The White Paper proposed sweeping changes to the taxation of farmers. The most important were:

- Replacement of cash accounting with modified accrual accounting;
- Use of an objective profit test (net income of at least $1 in three of seven years) to determine who is in the business of farming; and
- Use of a gross revenue test (gross revenue from farming greater than net income from other sources in three of seven years) to determine who is a full-time farmer.

These three changes were seen as a package. Additional changes were related to them - for example, an increase from $5,000 to $15,000 in the allowable deduction of farm losses against other income for part-time farmers, the change in the allowable write-off of the cost of race horses and show animals, the new treatment of start-up farmers, and the transition rules for the profitability requirement and gross revenue test.

Although the previous table shows that in 1981 there was over $1 billion in farm losses, the expected revenue gain from the White Paper changes was relatively modest. According to testimony before the Finance Committee by officials from the Department of Finance, it was "...

probably in the order of $50 million plus per year ... all of it from part-time or really hobby farmers."

Farmers were almost unanimous in opposing the move away from the cash accounting system. Many groups representing farmers sent briefs and appeared before the House of Commons Finance Committee to argue that the White Paper proposals were flawed and would lead to tax-motivated behaviour by farmers, a result at odds with the general thrust of the White Paper. The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants also pointed out that all farmers would be affected by the proposed changes although the problem has to do with only some part-time farmers.

In the light of this testimony, the Finance Committee recommended that the three proposals be dropped. The Committee also suggested that the need for a distinction between part-time and full-time farmers (the so-called section 31 problem) could be eliminated by basing the allowable deduction for farm losses on the amount of non-farm income. Accordingly, the Committee recommended:

> That individuals who qualify as being in the business of farming and use cash accounting for their farm business may deduct up to $10,000 of farm losses against other income, subject to a claw-back of this deduction. For example, those with off-farm income of up to $30,000 may have the full deduction; those with off-farm income greater than $30,000 will have the allowable deduction reduced by $1 for every $2 of income above $30,000.

Although the Committee admitted it did not have all the information necessary to estimate the exact cost of the example presented, it did believe "that the model provides a solution to a long-standing problem in the taxation of farmers."

The Department of Finance rejected this recommendation because it would have restricted the claims for losses of many farmers who considered themselves to be full-time farmers. The Department did, however, begin consultations with farm groups to develop alternatives to the White Paper proposals.

C. Bill C-139, An Act to Amend the Income Tax Act (30 June 1988)

Consultations with the farm groups were fruitful. By June 1988, the Department of Finance had prepared a set of proposals that the farm groups could accept. A Notice of Ways and Means including these proposals was tabled 13 June 1988 and Bill C-139, An Act to Amend the Income Tax Act, based on the Notice, was tabled soon after. It received Royal Assent in September 1988.

1. Changes from the White Paper

The tax reform legislation tabled 13 June 1988 deferred, pending further consultations, the objective profit test and the gross revenue test proposed in the White Paper and it retained cash accounting rather than introducing modified accrual accounting for farmers. It added:

a. mandatory adjustment for purchased inventory on hand for those farmers with a cash loss;

b. the option for all farmers to use the "flexible inventory election" for all inventory (this election is explained below);

c. an increase to the loss limitation in section 31 of the Act.

a. Mandatory Inventory Adjustment

According to the press release that accompanied the comprehensive Notice of Ways and Means (13 June 1988), the new inventory adjustment "will operate in a manner similar to the existing flexible livestock inventory election except that it will be mandatory, will apply only to purchased inventory and will apply only in loss years." This last point is important: the adjustment will bring a cash loss closer to a true economic or operating loss.

The accounting changes proposed in the White Paper would have been broader. They included changes in all inventories, accounts receivable, prepaid expenses and accounts payable from the beginning of the year to the end of the year.

As well, under the White Paper proposal, all farmers would have computed income by the accrual method, but a "cash basis reserve"

adjustment would have been permitted to give those with profits the benefits of the cash accounting system used in the past. With the new legislation, all farmers will compute income by the cash method. Only those with losses will be subject to the mandatory adjustment based on purchased inventory. Those with profits will continue to enjoy the benefits and simplicity of cash accounting.

Farm income is notoriously uncertain, depending as it does on weather and on prices set outside Canada. It is plausible, therefore, that over a reasonable period of time - say, five or ten years - most farmers would have one or more years of cash losses, and would have to face the complexity of the mandatory inventory adjustment. It is not possible, however, to calculate exactly what proportion of farmers would at some time have to do so.

b. Flexible Inventory Election

The "flexible livestock inventory" election was retained and the concept expanded to allow farmers to smooth out their recorded income over time. (As such it is a partial substitute for the block averaging that farmers and fishermen will no longer be able to use.) It will apply to all inventory, not just purchased inventory.

The flexible livestock inventory adjustment was introduced in 1971 when the capital asset treatment of basic herds was eliminated. With this adjustment, farmers using cash accounting may add to their income for tax purposes an amount based on the fair market value of their livestock inventory. The amount may range from zero to the full value of the livestock; whatever amount is added in one year must be deducted from income the following year.

c. Section 31 Limits

As the press release of 13 June 1988 noted:

> Section 31 of the Act, which restricts the amount of farm losses that are deductible against other sources of income for certain part-time farmers, is amended to increase the applicable loss limitation from the present \$2,500 plus one-half of the next \$5,000 to \$2,500 plus one-half of the next \$12,500 of losses in a year.

This increase is reasonable, given that the losses with reform will be closer to economic losses than is now the case with unadjusted cash accounting.

2. Transition Period

There will be a seven-year phase-in period for the measures. This relatively long transition is to adjust for the inventory purchased before 1989 and on hand as the new system takes effect. The adjustment--what Finance calls transitional relief--may take either of two forms: a "fixed dollar" method or a proportion of inventory on hand.

This choice of adjustment is probably the most complicated part of the new system. The Department of Finance has pointed out that the second option was added because farm groups--especially those with large cattle holdings--wanted an adjustment based on the proportion of inventory on hand. In other words, part of the complexity in the new system is there because the farmers wanted it.

It should be noted that "inventory on hand" includes any that was purchased before 1 January 1989. There are several reasons for this inclusion:

- inventory "left over" at the end of 1988 has been used to reduce income in 1988 (or previous years), so the calculated cash position before 1989 would not reflect the true economic position;
- exclusion of purchased inventory on hand at the start of 1989 could bias the recorded loss for that year (and subsequent years);
- for the "fixed dollar" method of transitional relief, exclusion of purchased inventory on hand at the start of 1989 would add complexity to the calculation of the mandatory inventory adjustment - the farmer would have to keep track of two sets of inventory, that purchased before and that purchased on or after January 1, 1989.

3. Land Improvement Costs

A relatively minor adjustment to the computation of farm income has to do with land improvement costs. The section providing for a

deduction for the laying of tile drainage has been extended to all types of land drainage systems. A farmer will be able to carry forward undeducted expenditure (full cost less the amount deducted in the first year) to a subsequent year.

4. Capital Gains

Under tax reform, the exemption for capital gains was capped at $100,000 except for farmers and small businesses, for whom the cap is $500,000. Family farm corporations are not, however, able to sell part of the farm and shelter the first $500,000 of capital gain. Farmers who have not incorporated, on the other hand, will be able to do so. Though some farm groups object to this inconsistency, there are several reasons for it:

° the exemption for the roll-out of assets from <u>any</u> corporation is not now available,

° attempting to treat farm corporations differently from other corporations would be complicated,

° farmers chose to incorporate so they would be treated differently and reap a tax advantage as corporations, and

° sheltering the capital gain from the sale of part of a farm may reward land speculation instead of farming.

As the first two reasons highlight, any attempt to treat all farming operations in the same way would mean that not all corporations would be treated in the same way. Such different treatment would necessitate very complicated changes to the <u>Income Tax Act</u>. Moreover, if non-farm corporations successfully agitated for similar tax breaks, the revenue loss could be large.

5. Valuation Rules

Special valuation rules will apply to horses and other specified animals:

° a 30% "depreciation" rule will be in effect;

- ° the value for tax purposes of specified animals on hand on 1 January 1989 will be:
  - (i) 100% of cost if purchased in 1988,
  - (ii) 50% of cost if purchased in 1986 or 1987, and
  - (iii) 25% of cost if purchased before 1986.

6. Debt Foreclosure

For the 1986 and subsequent taxation years, debt foreclosure will not affect the minimum tax base. As the press release of 13 June 1988 put it:

> On a debt foreclosure, an individual is treated as having received proceeds of disposition equal to the principal amount of the debt forgiven. In certain circumstances, the proceeds determined on this basis may exceed the value of the property and may give rise to a capital gain. For minimum tax purposes, the individual would be taxable on the full amount of the gain less the amount of the capital gain exemption allowed for regular tax purposes. To prevent hardship, the legislation will provide that any capital gain resulting from a foreclosure will be excluded from the minimum tax base.

7. Other Measures

Other tax measures that will affect farmers include:

- ° extension of the capital gains exemption to eligible capital property,
- ° elimination of block averaging,
- ° restrictions on automobile expenses, and
- ° restrictions on home office expenses.

Farm groups supported the first measure, which is of interest especially to farmers with quotas, but opposed the other measures.

8. An Objective Test to Determine Who is a Farmer

With the White Paper proposals the Department of Finance had hoped to provide objective tests - the profit and gross revenue tests - for determining whether someone who claimed to be a farmer was a full-time,

part-time or hobby farmer. Farmers opposed these tests, and the Department of Finance deferred their general implementation, pending further consultations with farm groups. A recent amendment to the Income Tax Act included in Bill C-139, however, retains one objective test proposed in the White Paper. This deals with the definition of "qualified farm property" eligible for the $500,000 capital gains exemption.

As the White Paper put it:

> Qualified Farm Property: The existing definition of qualified farm property will remain unchanged except with respect to farmland and buildings acquired after June 17, 1987 otherwise than pursuant to an agreement in writing entered into on or before that date. Qualified farm property will not include real property acquired after that date unless it was owned by the taxpayer, or the taxpayer's spouse or children for at least 24 months immediately before its disposition and:
>
> - in at least two calendar years, the gross revenues for a fiscal period ending in the year of the taxpayer, or the taxpayer's spouse or children, from the farming business in which the real property was used exceeded that person's net income from all other sources in the year, or
>
> - throughout any 24-month period, it was used by a family farm partnership or family farm corporation of the taxpayer or the taxpayer's spouse or children in the course of carrying on the business of farming in Canada.

This amendment was discussed extensively by the Finance Committee when examining Bill C-139 and was agreed to on division. It was noted that the objective test was only for property purchased after 17 June 1987 and that the Department of Finance was continuing to discuss with farm groups other objective tests and the section 31 problems. **These discussions have not led to other tests. Farm groups argued that the changes already made to the Income Tax Act should accomplish the desired goals, so there was no need for further changes. It appears that the Department of Finance will observe the working of the new legislation before deciding on any further measures.**

PARLIAMENTARY ACTION

A. White Paper on Tax Reform

On 18 June 1987 the government tabled before Parliament the White Paper, Tax Reform 1987. This document proposed sweeping changes to the taxation of farmers, including the replacement of cash accounting by modified accrual accounting and the use of objective tests to determine who is a farmer.

B. Bill C-139

Introduced and passed in the summer of 1988, Bill C-139 included major changes to the taxation of farmers. These changes, however, did not include the replacement of cash accounting or the introduction of general, objective tests to determine who is a farmer as recommended in the 1987 White Paper.

CHRONOLOGY

January 1985 -	The Department of Finance issued the discussion paper "Tax Issues in Agriculture."
April 1985 -	The House of Commons Standing Committee on Finance, Trade and Economic Affairs presented to the House of Commons its report dealing with the discussion paper "Tax Issues in Agriculture."
18 June 1987 -	Finance Minister Michael Wilson tabled in the House of Commons a Government White Paper on tax reform.
31 August 1987 -	The Department of Finance issued a press release clarifying the proposed tax treatment of farm inventories.
16 November 1987 -	The House of Commons Standing Committee on Finance and Economic Affairs issued its report on Stage One of the Government White Paper on Tax Reform.

December 1987 - The Department of Finance issued the paper "Tax Treatment of Farm Losses." This set out the approach discussed in consultations with farm groups begun after the tabling of the White Paper.

30 June 1988 - Bill C-139, An Act to Amend the Income Tax Act, was introduced into the House of Commons. After being discussed extensively and passed by the Finance Committee, it received Royal Assent in September 1988.

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